

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 97-0064
INDIANA CORPORATION INCOME TAX
For Tax Year Ending March 31, 1994**

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

- I. Disallowance of Taxpayer's Non-Business Income Deduction on Indiana Corporation Income Tax Return:** Litigation Settlement Income Characterized as Business or Non-Business Income.

Authority: IC 6-3-1-3.5(b); IC 6-3-1-20; IC 6-3-1-21; IC 6-3-2-2(a); IC 6-3-2-2(b); IC 6-3-2-2(g)-(k); 45 IAC 3.1-1-29.

Taxpayer protests the Department's determination that certain of taxpayer's income, received as the result of a litigation settlement, should be classified as apportionable business income. The taxpayer maintains that the income derived from an activity not normally undertaken by the taxpayer but was attributable to another company's negligence. Therefore, according to the taxpayer, in determining the taxpayer's adjusted gross income tax the income should be allocated as nonbusiness income to the taxpayer's home state.

STATEMENT OF FACTS

The taxpayer is incorporated and commercially domiciled in a state other than Indiana. The taxpayer operates helicopters in various states including Indiana. The taxpayer's helicopters are powered by engines produced by a manufacturer. Taxpayer brought a lawsuit against the manufacturer. Subsequently, taxpayer and manufacturer reached and concluded a settlement agreement whereby manufacturer paid a settlement to the taxpayer. The settlement amount was included within the taxpayer's federal income tax returns. The Department determined that the settlement income was properly characterized as "business income" and, as a result, was subject to the three-factor formula for apportioning business income. The taxpayer protested that determination, but waived its right to an administrative hearing. Taxpayer's representative was asked to supply information regarding the nature of the settlement amount. In the Department's correspondence, taxpayer's representative was asked whether the settlement awarded

taxpayer consisted of compensation for lost business revenues or compensation for faulty equipment. The taxpayer declined to respond or to provide additional information. Accordingly, this Letter of Findings has been prepared on the basis of the information contained within the Department's file and upon the basis of the taxpayer's written protest letter dated December 17, 1996.

DISCUSSION

I. Disallowance of Taxpayer's Non-Business Income Deduction on Indiana Corporation Income Tax Return.

Taxpayer protests the Department's determination that income, derived from a settlement agreement, constitutes business income and is subject to the three-factor apportionment set out in IC 6-3-2-2(b). Nonbusiness income is allocated to specific jurisdictions pursuant to IC 6-3-2-2(g)-(k). Business income apportioned to the state of Indiana, plus nonbusiness income allocated to Indiana, plus certain modifications required by IC 6-3-1-3.5(b), determines the total of the taxpayer's net income subject to the state's adjusted gross income tax. Taxpayer argues that the litigation award was acquired outside the regular course of its business and that the award should be directly allocated to its home state.

Under Indiana law, corporate adjusted gross income derived from sources within Indiana is reported as either business or nonbusiness income. IC 6-3-2-2(a). Under IC 6-3-1-20, business income is defined as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business." Nonbusiness income is defined in the negative and "means all income other than business income." IC 6-3-1-21.

Regulation 45 IAC 3.1-1-29 defines business income as that "income from transactions and activity in the regular course of the taxpayer's trade or business including income from tangible and intangible property if the acquisition, management, or disposition of the property are integral parts of the taxpayer's regular trade or business." That same regulation goes on to state that "[t]he classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, non-operating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is 'business income' or 'nonbusiness income' is identification of the transactions and activity which are the elements of particular trade or business." Id.

In determining the nature of income, states have employed one of two tests based upon the previous language. The regulatory phrase, “income from transactions and activity in the regular course of the taxpayer’s trade or business . . .” has led to the formulation of the “transactional test.” *Id.* Under this test, the nature of the particular transaction is critical in determining the nature of the income in question. The second test is the “functional test” and is derived from the language which states that “income from tangible and intangible property [represents business income] if the acquisition, management, or disposition of the property are integral parts of the taxpayer’s regular trade or business.” *Id.* In this second test, the particular use or function of the asset -- to which the income at issue is attributable -- within the taxpayer’s regular trade or business is used to categorize the income as either business or nonbusiness.

Taxpayer argues that the settlement agreement income should be classified as nonbusiness income because the income derives from an activity not normally undertaken by the taxpayer and because the income was not derived from its tangible or intangible property. Taxpayer maintains that it is in the business of providing transportation services and is not in the business of suing manufacturers. According to the taxpayer, the settlement agreement income is attributable not to any activity of, or asset belonging to, the taxpayer but is entirely attributable to the manufacturer’s negligence.

Taxpayer oversimplifies the issues and errs in its analysis. Taxpayer would have the Department conclude that the settlement agreement income arose in a vacuum entirely independent of and distinct from the taxpayer’s activities and assets. Clearly, the facts indicate otherwise. Taxpayer’s aircraft are central to the taxpayer’s business operations. Presumably, it was the purported deficiencies of taxpayer’s aircraft, critical to taxpayer’s business activities, which led taxpayer to seek compensation. Although taxpayer has declined to discuss in detail the basis for the action it brought against manufacturer or the basis for the settlement determination, it may be safely presupposed that taxpayer’s lawsuit was predicated upon the impact those deficiencies had upon its business activities and upon its physical assets. Similarly, it may be presumed that the amount of the settlement agreement was not determined capriciously. Whether based on the taxpayer’s lost business opportunities, damages sustained by its equipment, or the added expenses incurred by the taxpayer in maintaining the aircraft, the settlement agreement was inextricably linked to both taxpayer’s business activities and business assets.

FINDING

Taxpayer’s protest is respectfully denied.